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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)))	MM Docket No. 92-266
	)	
Rate Regulation	)	

COMMENTS OF THE NATIONAL CABLE TELEVISION ASSOCIATION, INC. IN RESPONSE TO THE THIRD FURTHER NOTICE OF PROPOSED RULEMAKING

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THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.
IN RESPONSE TO THE THIRD FURTHER NOTICE
OF PROPOSED RULEMAKING

The National Cable Television Association, Inc. ("NCTA"), by its attorneys, hereby submits its comments on the Third Further Notice of Proposed Rulemaking ("Third Notice") in the above-captioned proceeding.[1] NCTA is the principal trade association of the cable television industry, representing the owners and operators of systems serving more than 80 percent of the nation's approximately 57 million cable households. Its members also include cable programmers, cable equipment suppliers and others affiliated with the cable industry.

INTRODUCTION

The Third Notice seeks comment on four issues: (1) the appropriate methodology for adjusting rates when channels are added to or deleted from a regulated tier on a "going-forward" basis; (2) whether "below benchmark" cable operators who have completed rebuilds immediately prior to reregulation should be permitted to raise

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1 Implementation of Rate Regulation Sections of the Cable Television Consumer Protection and Competition Act of 1992, First Order in Reconsideration, Second Report and Order and Third Further Notice of Proposed Rulemaking, MM Dkt. No. 92-266 (rel. Aug. 27, 1993).

their rates to the benchmark level; (3) whether cable operators may elect either the benchmark or the cost-of-service approach for different tiers of regulated service; and (4) whether and how external treatment should be accorded the cost of upgrades undertaken after the initial date of regulation.

DISCUSSION

A. The Commission Should Apply Its "Going Forward" Approach On A Tier-Specific Basis

The question of how regulated rates are to be adjusted when channels are added or deleted on a "going-forward" basis (i.e., after the initial date(s) of regulation) is one of the most significant issues left unresolved by the Commission's initial Report and Order (and subsequent clarifications) in this proceeding. Resolution of the going-forward issue will have an enormous impact on cable operators, cable programmers, and cable subscribers. Indeed, the shape of the going-forward approach ultimately adopted by the Commission will shape the future of the cable industry -- whether new services are offered as part of regulated packages or a la carte and, consequently, the character of such new services.

There are a wide variety of possible going-forward methodologies. For example, one approach described and rejected by the Commission in the Third Notice involves determining a new benchmark rate based on the increased number of channels and applying that rate both to existing channels and to the new channels.[2] As the Commission points out, such an approach would create enormous disincentives for many systems to add new channels to a regulated tier.[3] Another approach, also considered and rejected by the Commission, would limit the application of the recalculated benchmark rate only to the newly-added channels. According to the Commission, this approach does not lend

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[2] Third Notice at ¶138.

[3] Id.

itself to situations in which channels are deleted and could result in a windfall when channels are added.[4] Finally, there is a third approach under which changes in programming costs resulting from the addition or deletion of channels would be factored into the new rate. The Commission has tentatively decided to adopt a going-forward methodology that is a variation on this third approach.

Specifically, under the Commission's preferred going-forward methodology, a system first would take its initial Line 600 maximum permitted rate and deduct the average per channel programming cost. The system then would further adjust the Line 600 rate by decreasing (or increasing) it by a factor equal to the change in the benchmark table rates applicable to the system before and after the addition (or deletion) of the new channel(s). Finally, the system would add back to the adjusted Line 600 rate an amount equal to the average per channel programming cost, recalculated to reflect the cost of the added (or deleted) channel(s).

NCTA's preference is for an approach that is not so heavily influenced by the "curve" in the benchmark table. As NCTA has stressed throughout the proceeding, fundamental flaws in the survey on which the benchmarks are based, and in the methodology used to compile the benchmarks, render the benchmark table exceedingly suspect as a basis for establishing "reasonable" cable rates.[5] By emphasizing the effect of the benchmark curve, and thus sharply restricting the return that a system can receive when it adds a channel to a regulated tier, the Commission's approach perpetuates and

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4 Id. at ¶137.

5 See, e.g., NCTA Petition for Reconsideration, MM Docket No. 92-266 (filed June 21, 1993) at 10-19.

exacerbates the defects in the Commission's initial decision.[6] Consequently, a much better approach would be one that, at very least, limits the application of any new rate only to the newly added channels.

Nevertheless, while the Commission's approach has significant drawbacks and disincentives, it represents an improvement over the first going-forward approach described above. Moreover, with certain important clarifications and modifications, some of the more egregious disincentives and negative consequences of the Commission's approach could be corrected. Most significantly in this regard, it is essential that the Commission make clear that its going-forward methodology applies on a "tier-specific" basis rather than a "tier-neutral" basis. In other words, where a cable system that offers multiple tiers of regulated service adds channels to (or deletes from) one of its regulated tiers, the going-forward rate adjustment should apply only to the tier with the increased (or decreased) level of service and not to the otherwise unaffected tiers. Any other result is unnecessary and will have unintended and perverse consequences.

In particular, applying the Commission's going-forward approach on a tier-neutral basis, in a number of circumstances, will cause a cable operator to suffer a net loss in revenue if the operator adds a channel to a regulated tier. For example, take a cable system with a 15 channel basic tier and a 20 channel expanded tier. Assume that 100 percent of the system's 10,000 subscribers take basic and 50 percent (or 5,000) of the subscribers also take the expanded tier. Assume further that, under the Commission's proposed going-forward formula, the addition of a new satellite service to the expanded

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6 Indeed, the Commission's approach does not ensure that an operator will receive the same net (i.e., after programming cost) return for adding a channel after September 1, 1993 that it would have received had it added the channel before September 1, 1993.

tier causes the system's maximum permitted per channel rate to drop from .60 cents to .588 cents. Even though the permitted expanded tier price increases from $12.00 (20 x .60) to $12.35 (21 x .588), the increase in revenue from that tier is more than offset by the lost revenue from the reduction of basic tier from $9.00 (15 x .60) to $8.82 (15 x .588).[7] Another perverse result of applying the Commission's approach on a tier-neutral basis is that it can cause rates to go up for subscribers whose service level has not changed. For example, if the addition of a new channel to the expanded tier of the system described above caused its maximum permitted rate to increase from .60 to .607 (a situation that could arise if the newly added channel was expensive in relation to existing programming costs), the rate for basic service would jump from $9.00 to $9.12, even though the level of service provided basic-only subscribers will remain unchanged. The political ramifications of such a result are obvious.[8] Nor is the solution to say that cable operators are not required to increase the basic rate when the basic service level is unchanged (or to prohibit such increases). If the operator cannot or does not increase the basic rate, a

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7 See Appendix A. While the Third Notice does not specifically indicate how programming costs are to be computed for purposes of applying its going forward formula, it is our understanding that an average cost per subscriber-channel is to be calculated (pursuant to the same methodology used in Form 393). That being the case, the result described in the text will obtain regardless of the cost of the added channel (i.e., the same loss in revenue will occur, all other facts being the same, whether the new channel costs .10, .50, a dollar, or is free). Moreover, in a tier-neutral scheme, using other methodologies to compute the average program costs (e.g., straight averaging, average per subscriber, per channel) will create even greater distortions and losses.

8 The situation is even more perverse than it might seem. As hard as it may be to believe, even though rates have increased for both basic and expanded tier subscribers, the increased revenues received by the system will not cover the cost of the new programming and the system still will lose money! The reason for this seemingly counter-intuitive result is indicated in the preceding footnote. See also Appendix B.

system that would otherwise see a net gain could actually incur a net loss and would be discouraged from adding new service on anything but an a la carte basis.[9]

It is not our intention by the above examples to suggest that the Commission's going-forward approach, if applied on a tier neutral basis, will result in a net loss whenever a new channel is added. The precise impact will vary depending on such factors as the number of channels on the tier to which channels are added relative to the overall number of regulated channels and the number of subscribers to the affected tier relative to the overall number of subscribers. It is undeniable, however, that in many situations, the Commission's formula, if applied on a tier neutral basis, will destroy any incentive for adding new channels to regulated service.[10] Moreover, applying the Commission's going-forward methodology on a tier-neutral basis will deter the introduction of new regulated tiers since the cable operator will not be able to predict whether enough subscribers will take the new tier to offset the lost revenues from lower rates on the preexisting tiers.

Apart from the above-described economic anomalies (and consequent injury to cable operators, programmers and subscribers), the Commission needs also to consider the confusion and public relations problems that will accompany the tier-neutral application of its going-forward methodology. As indicated, the addition of a channel to

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9 For example, if the system described above had sixty percent of its subscribers taking the tier, raising the maximum permitted rate (by adding an expensive new channel) would give the system a slight net gain if the new rate is applied to the rates for both the basic and expanded basic service tiers. However, if the system was able only to increase the rate for the expanded service tier, the loss of additional revenue from basic-only subscribers would cause the system to suffer a significant net loss of revenue. See Appendix C. As described infra, a true "tier-specific" approach can avoid this result.

10 Even where the Commission's approach results in a net gain in revenues over the new programming cost, the size of that gain may not be enough to cover the other costs (hardware, marketing, etc.) associated with the launch of a new channel.

an expanded tier will put cable operators in the position in some cases of having to raise rates for basic-only subscribers whose service level has not changed, a result that will be difficult to explain to customers, franchising authorities, and others. Even where tier neutrality causes basic rates to go down, cable operators will have to expend significant resources notifying customers and answering their questions. And similar difficulties will arise if services are added to the basic tier. For example, if the addition of a channel to the basic tier causes the maximum permitted per channel rate to go down, basic-only subscribers will see their total bills increase by a larger amount than expanded tier subscribers, even though both will have received the same change in service.[11] The inevitable outcome will be complaints and demands that local governments or the FCC remedy the situation. And if a system has three or more regulated tiers, the confusion and discontent will multiply.

One other set of problems created by a tier neutral approach to the going-forward issue involve the implementation and enforcement of rate changes. As discussed, addition of a channel to an expanded tier can result in a price increase for basic tier rates as well. The increase in the expanded tier rate can be implemented on 30 days' notice and is subject to review (with potential rollback and refund liability) upon complaint. It is not clear that the going-forward increase in basic rates, however, can be implemented until the new rate has been approved by local officials, a process that could take as long as four months (plus any time for judicial review). Until the basic increase is implemented, the

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[11] The result described above occurs because, for subscribers taking the expanded tier as well as basic, the reduction in the price for the expanded tier will offset some of the increase in the basic service rate. For example, if the addition of a sixteenth channel to a 15 channel basic tier causes the maximum permitted rate to drop from .60 to .59, basic-only subscribers' bills will go up by 44 cents from $9.00 (15 x .60) to $9.44 (16 x .59); tier subscribers overall bills will go from $21.00 (35 x .60) to $21.24 (36 x .59), an increase of only 24 cents.

operator could be incurring significant losses, since payments to the programmer for the new channel will be due throughout this period.[12] Similarly, where the addition of a channel to an expanded tier causes the maximum permitted rate to decline, local officials are likely to contend that there has been an implicit rate increase on basic service and will seek to force operators to decrease their basic rate even though the level of service has not been reduced.

Given the various problems and pitfalls detailed above, there can be no doubt that application of the Commission's going-forward approach on a tier neutral basis would not serve the public interest and that the Commission must clarify that it does not intend such a result. NCTA has argued unsuccessfully throughout this proceeding that tier neutrality is inconsistent with the 1992 Cable Act. Indeed, NCTA believes that many of the concerns that have been expressed, and now realized, regarding the implementation of the Commission's benchmark methodology are the direct result of a rigid and misguided adherence to tier neutrality.

Even if the Commission is unwilling to revisit application of tier neutrality to the initial restructuring of cable rates, fidelity to tier neutrality in the context of the addition or deletion of channels on a going-forward basis is simply unnecessary. Indeed, in its initial Report and Order in this proceeding, the Commission expressly acknowledged that tier neutrality is not an absolute: "The permitted charge per channel, prior to adjustments for inflation and external costs, will be the same for all tiers."[13] If, as the Commission concedes, external costs and inflation can lead to different permitted rates for different

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[12] The ability of local governments effectively to restrain cable operators from adding a new programming service by requiring prior approval of the rate for the new channel also has First Amendment implications.

[13] Report and Order, at ¶197 n.501. See also id. at ¶355 n.607 (initial permitted rates may differ because of difference in the initial date of regulation).

tiers, attempts to apply the Commission's going forward approach on a tier neutral basis would appear to be destined to fail. Just as it is the case that a dramatic increase in the cost of a network offered on one particular tier need not and should not effect the rates charged for other tiers (a point which NCTA urges the Commission to reiterate lest confusion develop), so too is it the case that an increase (or decrease) in the level of service offered on one particular tier need not and should not effect the rate for other tiers.

Applying the Commission's going-forward approach on a tier specific basis will cure some, but not all, of the potential problems and disincentives that would otherwise result (and that have been described above).[14] In addition there are several other adjustments that the Commission should make in its going-forward proposal.

First, in order to be truly tier specific, the Commission's approach must calculate average programming costs on a tier specific basis as well. If average programming costs are calculated across all channels, even on a weighted "per subscriber channel" basis, but then recovered only on a tier specific basis, the addition of more expensive new programming services could lead to a system incurring losses. Computing average programming costs on a tier specific basis (i.e., total cost of programming on the tier per subscriber divided by total number of channels on the tier) will avoid this result (and the concomitant disincentive it would create) and has the added benefit of being easy to calculate.

Second, although tier specific application of the Commission's going-forward approach will resolve many of the enforcement and implementation problems described

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[14] It should be noted that, even applied on a tier specific basis, the Commission's going forward approach fails to address the particular problems faced by "below benchmark" systems. Because such systems typically have low rates relative to their programming costs, they earn lower returns. The Commission's approach does nothing to correct this situation.

above, one situation still needs to be addressed. Specifically, where a system adds a channel to a basic tier, resulting in a rate increase for that tier, the system could be forced to wait four months before it is allowed to implement the new rate. Under the current rules, the operator has two choices: run the risk of operating at a loss for several months (with no hope of recovering the losses) or delay launch of the new service until the proposed increase has been approved at the local level. Neither of these results benefit the public. NCTA submits, therefore, that the Commission should allow cable operators adding channels to the basic tier to implement the new rate upon thirty days' notice, subject to potential refund liability if the rate ultimately is determined to be unreasonable.[15]

Third, if the local franchising authority strikes down a going-forward rate increase (either before it is implemented or afterwards), the Commission should automatically stay the decision pending review subject to refund liability. This approach will minimize the disruption of relationships between cable operators and programmers and the creation of confusion among subscribers (which will occur if a system announces and promotes the introduction of a new channel only to have the local franchising authority disapprove the proposed rate even before the channel is launched). It will also reduce worrisome local

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15 NCTA submits that instances in which a franchising authority rejects a proposed going forward increase should be rare, since the calculation of the rate will involve a relatively simple arithmetic exercise. In order to facilitate the introduction of new programming, and consistent with the Commission's statutory obligation to minimize the administrative costs associated with rate regulation, the Commission should indicate that a sworn declaration attesting to the accuracy of a system's calculation of its programming cost is sufficient and should prohibit local franchising authorities from engaging in costly and intrusive fishing expeditions into the highly sensitive area of program contracts.

intrusion into the constitutionally protected activity of program selection by the operator.[16]

Finally, NCTA submits that the Commission should adopt a "grace period" applicable to situations where the number of channels on a tier decreases on a temporary basis. Channels sometimes become unavailable for reasons outside a cable operator's control. For example, a broadcast station may be removed for technical, financial, or legal reasons, often with little or no notice.[17] Similarly, satellite cable program networks also can become suddenly unavailable because of displacement by must carry, commercial leased access or PEG programming or due to contract disputes arising in the environment of reregulation. While cable operators generally attempt to restore service or replace the unavailable channels as soon as they are able, arranging carriage of substitute programming and notifying subscribers of the changes can take time. It would be incredibly disruptive and confusing if cable operators had to readjust their rates every time the level of service on a tier was temporarily reduced.[18] Cable subscribers do not have to pay for any increase in service until they have been given a minimum of 30 days (and frequently longer) notice of any rate change.[19] Furthermore, subscribers are entitled

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[16] Again, because the Commission's going forward methodology involves the application of a simple arithmetic formula, disputes should be rare and, where they arise, presuming that the rate is justified and that the burden of proving otherwise is on the franchising authority is appropriate.

[17] One possibility, for example, is that if a station and cable system are unable to reach agreement on retransmission consent by October 6, 1993, the system will be forced by law to discontinue carriage of the station; it is possible, however, that, after a relatively short period, the parties will reach an accord and carriage of the station will resume.

[18] Indeed, since operators must give prior notice whenever prices go up or down, an operator who loses access to a service temporarily, and then restores the prior level within a month or two, could find itself literally in an endless (and very expensive) cycle of notices.

[19] See e.g. 47 C.F.R. §§76.309(c)(3)(i)(B); 76.932.

(Footnote cont'd.)

under the Commission's rules to an additional period of 30 days to downgrade once notified of any rate increase or retiering.[20] Consequently, NCTA urges the Commission to allow operators similar leeway to retain an otherwise permissible rate after service is reduced so long as the prior level of service is restored within 60 days.

B. Operators Who Initiated Upgrades Shortly Before Rate Regulation Should Be Permitted to Raise Rates to the Benchmark

In the initial Report and Order in this proceeding, the Commission determined that cable systems with rates below the presumptively reasonable benchmark level would not be permitted to raise their prices up to the benchmark level.[21] Upon reconsideration, the Commission reaffirmed its decision to "cap" below benchmark systems, asserting that there was no evidence to suggest that a system which had "voluntarily selected" to price its service at below benchmark levels in the absence of regulation was failing to recover its costs.[22] The Commission further noted that, as with all other cable systems subject to regulation, below benchmark systems may make a cost-of-service showing if necessary to justify higher rates than permitted by the benchmark/price cap regulatory scheme.[23]

While adhering to its decision effectively to "freeze" the prices charged by below benchmark systems at levels beneath the presumptively reasonable benchmark rates, the Commission has indicated that it is considering relief for those below-benchmark systems that rebuilt or upgraded their facilities shortly before the advent of rate regulation. Ordinarily, under the Commission's rules, upgrade and rebuild costs are recoverable only

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(Previous footnote cont'd.)

20 See 47 C.F.R. §76.980(f).

21 Report and Order at ¶232.

22 Reconsideration Order at ¶14.

23 Id.

through a cost-of-service showing.[24] With respect to recently improved below-benchmark systems, however, the Commission has asked whether it should adopt a "streamlined" cost-of-service procedure. As an alternative, the Commission also is considering whether it should simply permit such systems to raise their rates to the benchmark level.[25]

NCTA submits that, at a minimum, cable operators who voluntarily upgraded their systems before regulation should be allowed to raise their rates to the benchmark with no cost-of-service showing. The relationship of a system's rates to the benchmark reflects only a snapshot of rates at a particular point in time. Operators who prior to rate regulation incurred the costs of rebuilds and upgrades should not be penalized because they decided to phase in rate increases over time, rather than raising rates to recover those costs at once. Indeed, before rate regulation, cable operators often adopted pricing strategies that incorporated gradual changes in rates charged to subscribers as the means to recoup their modernization of cable plant. It is only fair now that an operator who demonstrates that it has recently upgraded or rebuilt the system be allowed to recover these wholly legitimate costs.[26] Accordingly, the Commission's rules should enable operators who rebuilt or upgraded their system within three years before rate regulation commenced to automatically raise their rates to the benchmark.

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[24] Id. ¶97. As discussed infra, the Commission has proposed, and NCTA supports, allowing external "pass-through" treatment of upgrades and rebuilds required by franchising authorities.

[25] Third Notice, ¶145. See also id. at ¶14 n.25.

[26] Establishing the fact of a recent rebuild or upgrade should not require an administratively burdensome showing. The fact that a system has significantly increased its total activated channel capacity by at least five channels should be sufficient. Other indices of a recent rebuild or upgrade might include installation of new addressable headend equipment and converter boxes, new amplifiers and/or fiber plant or the extension of facilities to previously unserved areas.

The Commission also should establish a mechanism, short of a full scale cost-of-service proceeding, for any voluntary upgrade or rebuild expenditures for systems whose rates are already at the benchmark. Congress specifically encouraged the continued expansion of cable systems.[27] The Commission should facilitate this policy by adopting rules that would serve as an incentive, not an impediment, to such improvements. Requiring an operator to undergo a full-blown cost-of-service proceeding whenever it seeks to raise rates to recoup the cost of a system upgrade or rebuild could act as a significant deterrent to improvements and ultimately would deny consumers the benefits of new cable technology and service offerings.

Moreover, streamlining cost-of-service procedures for system upgrades will lessen the regulatory burdens of the FCC and local franchising authorities, which otherwise would have to engage in time-consuming administrative proceedings to ascertain allowable rate adjustments. Under an abbreviated cost-of-service showing, operators would submit only the costs of the upgrade instead of all current costs. Assuming compliance with cost allocation requirements, the costs of the upgrade would then be added to the rate permitted under the benchmark and price cap approach to the extent costs could not be recovered under that approach.[28]

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27 Cable Television Consumer Protection and competition Act of 1992, §2(b)(3).

28 See Notice of Proposed Rulemaking, MM Docket No. 93-215, released July 16, 1993, ¶75. As the Commission notes, "this approach could reduce burdens on cable operators and regulators by eliminating the need for development and examination of all costs to support the desired rate, while permitting operators to make facility and service improvements." Id.

C. **Operators Should Have Discretion to Select Benchmark or Cost-of-Service for Different Regulated Tiers**

The Commission has tentatively concluded that operators should be required to elect a uniform rate-setting mechanism for all regulated tiers. It believes that such uniformity -- i.e. either an all benchmark or an all cost-of-service approach -- is necessary to protect its decision to establish a tier neutral benchmark system and to eliminate incentives to "game" the regulatory process.[29]

As the Third Notice points out, the cable industry has already put forth a host of reasons why operators should not be forced into a singleton regulatory scheme for all regulated tiers. Maintaining operator discretion to elect either the benchmark or cost-of-service approach is important, for example, because cost structures may significantly differ among individual tiers. Moreover, if the operator is inclined to take a split approach, the result of a uniformity requirement will likely put all tiers on a cost-of-service basis, since the operator believes the benchmarks are inadequate to insure recovery of costs plus reasonable profit on the system overall. Insisting on uniformity will not drive operators to greater reliance on the benchmarks for this reason. It also is very unlikely that operators will be able to offer a low-cost lifeline basic service -- as intended by the Act -- without the ability to seek a reasonable return via cost-of-service showings for expanded service tiers. Furthermore, a uniform rate scheme will burden the regulatory process by increasing the likelihood that cable operators will be forced to engage in cost-of-service showings (since the benchmark price could be inadequate across-the-board for all tiers) and by requiring operators to make cost-of-service showings before two different regulatory bodies.

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[29] Third Notice at ¶149.

The Commission tentatively has found, however, that parallel showings are necessary because of its tier neutral scheme and, as NATOA argues, because operators may "game" the regulatory process by retiering and other actions. We submit that these concerns are unwarranted. First, NATOA has presented no evidence to show that cable operators have the incentive or means to engage in the "gaming" behavior described in the Third Notice. If an operator attempts to lower its programming costs on its basic tier, the Commission's external price cap adjustment rules will require a decrease in the price of the basic tier to reflect the reduction in costs.[30] Similarly, the external pass through rules allow an operator to recover higher programming costs without the burden, uncertainty, or delay inherent in a cost-of-service showing. Under the circumstances the "gaming" strategy feared by NATOA and the Commission makes no sense.

Second, the Commission's desire to maintain tier neutrality will not be achieved by a uniform rate-setting scheme because the operator selecting cost-of-service will have to present its case before two different regulatory bodies.[31] In this situation, there is absolutely no assurance that cost-of-service principles will result in the same rate on a per-channel basis for each regulated tier. Thus, the uniformity and consistency that the Commission seeks will be negated and the partial uniformity of one tier under benchmark will be lost, since the operator's need to proceed by cost-of-service on one tier will not go away. At a minimum, therefore, as NCTA and other parties have urged the Commission, where a cable operator elects to justify both basic and non-basic rates through cost-of-service showings, it should be done in a single FCC proceeding. It is far more efficient

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30 See 47 C.F.R. §76.922(d)(2).

31 In addition, as discussed above with respect to the "going-forward" issue, tier neutrality is neither required nor practical after the initial rate setting period.

and rational to authorize the Commission to conduct one cost-of-service proceeding than conduct two independent proceedings.

Finally, where an operator opts for a different rate-setting approach for different tiers, there is nothing to prevent the regulator in the cost-of-service proceeding from considering what is occurring on other regulated tiers. For example, in a cost-of-service proceeding the Commission can evaluate the reasonableness of a challenged non-basic tier rate in light of the costs and the rates associated with the other tiers.[32] Moreover, if necessary, the Commission can take steps to ensure that there is no improper allocation of costs to one service tier.[33]

The Commission's concern here is to preclude operators from manipulating the benchmark system in order to achieve higher than justified rates. But if an operator takes the risk of an uncertain cost-of-service showing as opposed to a pre-determined benchmark rate, the Commission and local franchising authorities have the ability to ensure that operators only derive the appropriate cost recovery. Therefore, the Commission should permit operators the discretion to pursue the rate-setting mechanism that best suits its regulated service tiers.

D. Costs Of Upgrade Required By Franchising Authority Should Be Recovered As External Pass-Throughs

In its First Reconsideration Order, the Commission affirmed its initial decision to allow cable operators to pass through to subscribers certain costs incurred to satisfy

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32 See e.g., 47 U.S.C. §543(c)(2)(D) (instructing Commission to consider "the rates, as a whole, for all the cable programming [Other than per channel and per program services]; cable equipment, and cable services provided by the system" in evaluating non-basic rates").

33 The Commission already controls allocations, at least theoretically, in the benchmark rate.

franchise requirements, including PEG access channels and other services.[34] The Commission determined that eligibility for external cost treatment rests on whether or not the costs are specifically enumerated in the franchise agreement. The Commission questions, however, the status of upgrade expenditures under this policy.

While the Commission appears properly inclined to allow operators to pass-through upgrade costs required by the franchise, it asks nonetheless whether external treatment could undermine the benchmark/price cap scheme by significantly raising rates in line with costs. We strongly believe that upgrades should not be treated any differently than other franchise requirements and that operators should, therefore, be able to automatically adjust their rates to recover such costs.

As the Commission notes, it is guided by statutory language which directs the agency to adopt a regulatory framework for basic service that takes into account, inter alia, the costs of compliance with certain franchise requirements. And in generally according external cost treatment to franchise requirements, the Commission has recognized that such costs are largely beyond the control of the cable operator and thus should be passed on to subscribers without a cost-of-service showing. With regard to mandated upgrades, the Commission appropriately notes that local authorities are in a position to weigh the potential impact of any cost increases on subscribers at the time they require system changes.[35]

Moreover, foreclosing operators' ability to recoup capital costs incurred in accordance with the franchise by passing them through to subscribers could inhibit

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[34] See First Reconsideration Order ¶101. In addition to franchise requirements, certain categories of other costs including programming cost increases and taxes are entitled to external cost treatment to the extent they exceed inflation.

[35] Id. at notes 160 and 176.

investment in new technology and new services for the benefit of consumers. It also could jeopardize the financial viability of the system by forcing operators to rely on burdensome and potentially time-consuming cost-of-service proceedings whose outcome is completely uncertain.

Under these circumstances, there is no reason for the Commission to limit the scope of franchise-required costs that cable systems are permitted to pass through to subscribers. Where the upgrade or rebuild is specifically required in the franchise documents, such costs should qualify for an automatic rate adjustment.[36] In addition, the Commission should develop an efficient mechanism to enable operators to recover such upgrade costs where it is not prudent to take the full increase all at one time. In such circumstances, the operator may want to gradually phase-in the increase at a rate higher than the inflation rate. Absent a phase-in schedule, the operator could be forced to undergo a full-scale cost-of-service hearing every time it wishes to increase rates above the benchmark as part of a staggered compensation scheme. This will serve no regulatory purpose and surely overburden the administrative process.

If, notwithstanding its clear benefits, the Commission rejects an external pass-through approach to the recovery of rebuild and upgrade costs, the Commission at a minimum should adopt procedures for abbreviated cost-of-service showings for such situations. These procedures should be the same as those discussed earlier with respect to

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[36] External treatment should not necessarily be limited to upgrades or rebuilds expressly referenced in a formal franchise document. Where a franchise authority is willing to abide by the Commission's pass-through rules for rebuilds and upgrades (including any rules relating to the phase-in of rebuild-related rate increases) rather than subject both itself and the cable operator to a costly and time-consuming cost-of-service proceeding, the franchise authority should be permitted to signal its agreement to the rebuild/upgrade and, thereby, trigger external treatment. What a franchising authority should not be permitted to do, however, is dictate, a different schedule or set of terms than specified by the Commission's rules for the recovery of rebuild/upgrade costs on a pass-through basis.

pre-regulation upgrades, including procedures for gradually phasing in rate increases designed to recover upgrade/rebuild costs. Under no circumstances, however, should the Commission permit local franchising authorities to determine the manner in which rates will be adjusted to reflect the cost of required upgrades and rebuilds. Granting local control over recovery of mandated upgrades would open up the process to unwarranted and unnecessary micro-management. It also could foster outright abuse by local franchise authorities who, on the one hand, can directly or indirectly require certain system upgrades while, on the other hand, retain the right to determine the allowable rates and schedule for recovery of such costs. The process will operate more equitably and more efficiently on both sides if the local regulator and the local cable system understand up front that system improvements agreed upon by the franchising authority will be accorded external treatment. Such an approach also will ultimately benefit consumers.

Respectfully submitted,

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